



Local Agency Investment Guidelines: Update for 2003

(Reflects State Law Changes Effective January 1, 2003)

CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

The California Debt and Investment Advisory Commission was created in 1981 to assist state and local governments to most effectively and efficiently issue, monitor and manage public debt. In 1995, the Commission's responsibilities were expanded to include a municipal education program to help local governments to safely and effectively invest public funds. To carry out its responsibilities, the Commission maintains a database of all public debt issued in California, conducts a continuing education program, publishes a monthly newsletter with debt issuance data and informative articles, and conducts research to develop reports, guidelines and briefs on topical issues related to public debt issuance and investment practices.

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INTRODUCTION

The aftermath of the Orange County investment pool failure and bankruptcy filing in December 1994 prompted numerous reports, special hearings, and committees to assess what went wrong and suggest measures to avoid similar problems in the future. Most notably, the Governor convened the Task Force on Local and State Investment Practices to review the situation and recommend investment guidelines to the California Legislature. It was comprised of representatives from various statewide organizations and members of the Legislature.

The Task Force and other members of the state investment community prepared and presented to the Legislature a package of legislative proposals to improve investment practices of local agencies. These activities culminated in the California Legislature's enactment in late 1995 of numerous changes to the Government Code that restricted permissible investments and promoted oversight procedures for the management of public funds.

There was widespread support for the objectives of these new investment laws; however, many local officials expressed uncertainty over their implementation. To address these concerns, in 1996, the then-California Debt Advisory Commission (the "Commission") brought together a "working group" consisting of staff from the California Legislature and representatives from seven statewide associations to prepare what became the Commission's *Local Agency Investment Guidelines* (the "*Guidelines*"). The participating associations included:

- Association of California Water Agencies
- California Association of County Treasurers and Tax Collectors
- California Society of Municipal Finance Officers
- California Municipal Treasurers Association
- California Special Districts Association
- California State Association of Counties
- League of California Cities

The *Guidelines* were developed as an interpretive document meant to aid local officials in their efforts to implement the new laws. Since the original report's release in 1996, numerous statutory changes have occurred, including the addition to the Commission's mandate the responsibility of providing investment education and research. The Commission's name also was changed to the California Debt and Investment Advisory Commission (CDIAC). In keeping with its expanded mandate, CDIAC has revised these *Guidelines* to include statutory changes that have occurred since 1996 in order to provide local agency investment officials and interested parties with the most accurate, up-to-date information available. The information reported in these *Guidelines* reflect statutory changes to the State Government Code effective as of January 1, 2003.

This updated document retains much of the same format as the original document; that is,

it briefly describes each of the issues considered and offers a description of the minimum legal requirement for compliance with each section of the law. These descriptions represent the best judgment of the investment professionals involved, and are intended only as guidance for local agencies in their efforts to comply with the laws. The document also retains the working group's consensus recommendations from the original *Guidelines* where appropriate. Local agencies are advised, however, to rely only upon their legal counsel for legal advice.

The *Guidelines* are divided into four chapters:

- Chapter I. Annual Investment Policy
- Chapter II. Fund Management
- Chapter III. Reporting Requirements
- Chapter IV. Treasury Oversight Committees

There is one issue that does not fit neatly into one of these four chapters, and this concerns the applicability of the statutory changes to different types of jurisdictions. Generally speaking, it was the consensus of the working group that all local agencies, regardless of their characterization, are subject to the reporting, fund management, and investment policy requirements. (Only county governments are subject to the county oversight committee requirements.) All of these requirements are contained in the same article of the California Government Code dealing with public investments. That article begins with Section 53600, which states:

As used in this article, "local agency" means a county, city, city and county, including a chartered city or county, school district, community college district, public district, county board of education, county superintendent of schools, or any public or municipal corporation.

Any jurisdiction that assumes it is not covered by these provisions should seek the advice of its legal counsel.

The updated *Local Agency Investment Guidelines* also provide valuable information on how to properly manage public funds; however, it is also important to note that nothing can substitute for proper education/training of local treasurers, investment officers, and members of the legislative body/advisory committees in the area of public investments. In addition to this report, CDIAC offers investment seminars to provide local officials with relevant information to assist them with their responsibilities. CDIAC also has worked with a broad variety of interested parties to promote best investment practices through legislation, through the establishment of a toll-free Hotline (1-888-CDIAC49) for local agencies to confer with CDIAC regarding questionable debt and investment practices, and through the creation of a publication to disseminate timely information on such practices and other issues of vital importance to promoting and protecting the public trust.

CHAPTER I. THE ANNUAL INVESTMENT POLICY

The investment laws require all local agencies to develop an annual investment policy that must be considered by the legislative body and any oversight committee of the local agency at a public meeting. A good investment policy encompasses the cash, treasury, and investment management functions of an agency. It serves as a guide for setting and achieving program objectives, defines rules and establishes benchmarks, and reduces the exposure to liability of both the investment staff and the governing board. Finally, it is also important to note that rating agencies pay close attention to an agency's investment policy and portfolio in determining its credit rating.

I. A. How should the annual investment policy be submitted to the legislative body? [Section 53646(a)]¹

Section 53646(a)(1) requires the treasurer of a *county* government to annually render to his/her board of supervisors and oversight committee an investment policy, which the board is required to review and approve at a public meeting. In addition, the board must review and approve any changes to the investment policy at a public meeting.

Section 53646(a)(2) requires the treasurer or chief fiscal officer of any *other* local agency to annually render to his/her legislative body an investment policy and, if applicable, his/her oversight committee, which the legislative body shall “consider” at a public meeting. This raises questions about whether or not the policy should be adopted officially by the legislative body, and the time during the year that this “consideration” should take place.

Minimum legal requirement: The investment policy must be an agenda item at a public meeting of the agency's legislative body at some time prior to or during the year it covers. More specifically, section 53646(b)(2) states “The quarterly report shall state compliance of the portfolio to the statement of investment policy...”, which implies that the investment policy must be an agenda item at a public meeting prior to completion of the first quarterly report of the year. The board of supervisors of a county government must review and approve the investment policy and any changes to it at the public meeting. The law does not place the same specific approval requirements on other local agencies, nor does it specify when during the year that consideration or approval must occur.

Consensus recommendation: The investment policy should be thoroughly discussed by an agency's legislative and/or advisory body and approved by a vote of the legislative body, no later than the end of the first quarter of the year to which it applies. The reason it is important to have a vote is to give “teeth” to the investment policy by increasing its

¹ All “Section” references refer to the California Government Code unless otherwise noted.

authority and legitimacy. The annual policy also should be in effect for the treasurer to produce the required first quarter report—which must state compliance with the annual investment policy.

I. B. What must be included in the investment policy? [Section 27133]

With the exception of county governments, the investment laws do not contain any provisions specifying what must be included in the investment policy of a local agency. County investment policies must contain:

1. A list of allowable securities and instruments, according to the law, the maximum percentage by type of security, and the term of any security purchased;
2. The manner of calculating and apportioning the costs of the overall investing, handling, and managing of funds;
3. Limits on the receipt of honoraria, gifts, and gratuities for county treasury oversight members from advisors, brokers, dealers, bankers, or other persons with whom the county treasury conducts business;
4. Criteria for selecting brokers and dealers (including prohibitions against selecting any broker, dealer, or security firm within a 48 month period of making a campaign contribution exceeding the limitations contained in Rule G-37 of the Municipal Securities Rulemaking Board);
5. A requirement that the treasurer provide the county treasury oversight committee with an investment report as required by the Board of Supervisors.
6. Criteria for considering requests to withdraw funds from the county treasury; and
7. Terms and conditions under which local agencies that are not required to deposit funds may deposit funds if they so choose.

The last two of the above elements directly refer to the duties counties have in maintaining a local government investment pool. However, it would benefit any agency to include the other five elements in its own investment policy. A sample guide to creating an investment policy published by the Association of Public Treasurers of the United States and Canada is included in the Appendix to give additional details on items to include in an investment policy. The Government Finance Officers Association also has a sample investment policy available for purchase.

I. C. What constraints can county pools place on voluntary depositors? [Section 27133(g)]
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An area where questions commonly occur is how county pools should treat funds from voluntary depositors. Voluntary funds are often referred to as “hot money” because of the difficulty county treasurers have in predicting withdrawals of these funds. Failure to have adequate information on a depositor’s cash flow can lead to unanticipated withdrawals and introduce potential liquidity problems.

Minimum legal requirement: State law does not require county pools to accept voluntary deposits.

Consensus recommendation: Allow voluntary deposits only under a clearly written contract or memorandum of understanding. This agreement should spell out the exact rules for participating in the pool and provide the county treasurer with reasonable predefined discretion to establish the frequency and amount of voluntary funds that can be removed from the pool at a particular time. Another option is to ban voluntary deposits altogether, if the county has confidence that other local agencies have reasonable investment alternatives.

CHAPTER II. FUND MANAGEMENT

For the investment of county funds in a county treasury, Government Code Section 27000.3 establishes the Board of Supervisors as a fiduciary that is subject to the prudent investor standard unless it delegates its investment duties to the county treasurer. For other local agencies' funds invested in the county treasury, the county treasurer serves as a fiduciary and is subject to the prudent investor standard.

Except as provided for in Section 27000.3, Government Code Section 53600.3 declares each person, treasurer, or governing body authorized to make investment decisions on behalf of local agencies to be a *trustee* and therefore a *fiduciary* subject to the *prudent investor standard*. These persons shall act with care, skill, prudence, and diligence under the circumstances then prevailing when investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing funds. Section 53600.5 further stipulates that the primary objective of any person investing public funds is to safeguard principal; secondly, to meet liquidity needs of the depositor; and lastly, to achieve a return or yield on invested funds (Government Code Section 27000.5 specifies the same objectives for county treasurers and board of supervisors).

Risk is inherent throughout the investment process. There is risk assigned to any investment activity as well as opportunity risk related to inactivity. Market risk is derived from exposure to overall changes in the general level of interest rates while credit risk is the risk of loss due to the failure of the insurer of a security. The market value of a security varies inversely with the level of interest rates. If an investor is required to sell an investment with a 5 percent yield in a comparable 7 percent rate environment, that security will be sold at a loss. The magnitude of that loss will depend on the amount of time until maturity.

Purchasing certain allowable securities with a maturity of greater than five years requires approval of the governing board (see Government Code Section 53601). Part of that approval process involves assessing and disclosing the risk and possible volatility of longer-term investments.

Another element of market risk is liquidity risk. Instruments with unique call features or special structures, or those issued by little known companies, are examples of "story bonds" and often are thinly traded. Their uniqueness often makes finding prospective buyers in a secondary market more difficult and, consequently, the securities' marketability and price are discounted. However, under certain market conditions, gains are also possible with these types of securities.

Default risk represents the possibility that the borrower may be unable to repay the obligation as scheduled. Generally, securities issued by the federal government and its agencies are considered the most secure, while securities issued by private corporations or negotiable certificates of deposit issued by commercial banks have a greater degree of risk. Securities with additional credit enhancements, such as bankers acceptances, collateralized repurchase agreements and collateralized bank deposits, are somewhere

between the two on the risk spectrum.

The vast majority of portfolios are managed with a buy and hold policy. Investments are purchased with the intent and capacity to hold them until maturity. At times, market forces or operations may dictate swapping one security for another or selling a security before maturity. Continuous analysis and fine tuning of the investment portfolio are considered part of prudent investment management.

This strategy is not to be confused with heavy trading activity where securities are purchased with the intent to sell them before maturity at a profit or the use of leverage to enhance yield. Such strategies require predicting the future direction of interest rates.

The Government Code contains specific provisions regarding the types of investments and practices permitted after considering the broad requirement of preserving principal and maintaining liquidity before seeking yield. These provisions are intended to promote the use of reliable, diverse, and safe investment instruments to better ensure a prudently managed portfolio worthy of public trust.

II. A. Which investments are permissible? Which are prohibited? [Sections 16429.1, 53601, 53601.6, 53601.7, 53635, 53635.2, and 53684]

Government Code Sections 16429.1, 53601, 53601.6, 53601.7, 53635, 53635.2, and 53684 place a number of requirements on how and where public money may be invested. Figures 1 and 2 provide a synopsis of the permitted securities and conditions for using them.

Prohibited investments include securities not listed in Figures 1 and 2, as well as inverse floaters, range notes, interest only strips derived from a pool of mortgages, and any security that could result in zero interest accrual² if held to maturity, as specified in Section 53601.6.

² Zero interest accrual means the security has the potential to realize zero interest depending upon the structure of the security. Zero coupon bonds and similar investments that start at a level below the face value are legal because their value does increase.

Figure 1a
Allowable Investment Instruments
Per State Government Code (as of January 1, 2003)^a
Applicable to all local agencies^b

Investment Type	Maximum Maturity ^c	Maximum Specified Percentage of Portfolio	Minimum Quality Requirements
Local Agency Bonds	5 years	None	None
U.S. Treasury Obligations	5 years	None	None
State of California Obligations	5 years	None	None
CA Local Agency Obligations	5 years	None	None
U.S. Agencies	5 years	None	None
Bankers' Acceptances	180 days	40 percent ^d	None
Commercial Paper—Select Agencies ^e	270 days	25 percent of the agency's money ^f	"A-1/P-1/F-1"; if the issuer has issued long-term debt it must be rated "A" without regard to modifiers ^g
Commercial Paper—Others Agencies ^h	270 days	40 percent of the agency's money ⁱ	"A-1/P-1/F-1"; if the issuer has issued long-term debt it must be rated "A" without regard to modifiers ^g
Negotiable Certificates of Deposit	5 years	30 percent	None
Repurchase Agreements	1 year	None	None
Reverse Repurchase Agreements &	92 days ^j	20 percent of the base value of the portfolio	None ^k
Medium-Term Notes ^l	5 years	30 percent	"A" rating
Mutual Funds	N/A	20 percent ^m	Multiple ⁿ
Money Market Mutual Funds	N/A	20 percent	Multiple ^o
Collateralized Bank Deposits	5 years	None	None
Mortgage Pass-Through Securities	5 years	20 percent	"AA" Rating ^p
Time Deposits	5 years	None	None
County Pooled Investment Funds	N/A	None	None
Local Agency Investment Fund (LAIF)	N/A	None	None

*See "Table of Notes for Figure 1a" on page 9b for footnotes related to this figure.

Table of Notes for Figure 1a

- a. Sources: Government Code Sections 16429.1, 53601, 53635, and 53638.
- b. Municipal Utilities Districts have the authority under the Public Utilities Code Section 12871 to invest in certain securities not addressed here.
- c. Government Code Section 53601 provides that the maximum term of any investment authorized under this section, unless otherwise stated, is five years. However, the legislative body may granted express authority to make investments either specifically or as a part of an investment program approved by the legislative body that exceed this five year maturity limit. Such approval must be issued no less than three months prior to the purchase of any security exceeding the five-year maturity limit.
- d. No more than 30 percent of the agency's money may be in Bankers' Acceptances of any one commercial bank.
- e. "Select Agencies" are defined as a "city, a district, or other local agency that do[es] not pool money in deposits or investment with other local agencies, other than local agencies that have the same governing body".
- f. 10 percent of the outstanding commercial paper of any single corporate issuer.
- g. Issuing corporation must be organized and operating with the U.S. and have assets in excess of \$500,000,000.
- h. "Other Agencies" are counties, a city and county, or other local agency "that pools money in deposits or investments with other local agencies, including local agencies that have the same governing body". Local agencies that pool exclusively with other local agencies that have the same governing body must adhere to the limits set for "Select Agencies", above.
- i. No more than 10 percent of the agency's money may be invested in the Commercial Paper of any one corporate issuer; no more than 10 percent of the outstanding Commercial Paper of any one corporate issuer may be purchased by the local agency.
- j. Reverse repurchase agreements or securities lending agreements may exceed the 92-day term if the agreement includes a written codicil guaranteeing a minimum earning or spread for the entire period between the sale of a security using a reverse repurchase agreement or securities lending agreement and the final maturity dates of the same security.
- k. Reverse repurchase agreements must be made with primary dealers of the Federal Reserve Bank of New York or with a nationally or state chartered bank that has a significant relationship with the local agency. The issuer must have held the securities used for the agreements for at least 30 days.
- l. "Medium-term notes" are defined in Government Code Section 53601 as "all corporate and depository institution debt securities with a maximum remaining maturity of five years or less, issued by corporations organized and operating with the United States or by depository institutions licensed by the United States or any state and operating within the United States".
- m. No more than 10 percent invested in any one mutual fund.
- n. Must receive the highest ranking by not less than two nationally recognized rating agencies or the fund must retain an investment advisor who is registered with the SEC (or exempt from registration), has assets under management in excess of \$500 million, and has at least 5 years experience investing in instruments authorized by Government Code Sections 53601 and 53635.
- o. Must receive the highest ranking by not less than two nationally recognized statistical rating organizations or retain an investment advisor registered with the SEC or exempt from registration and who has not less than 5 years experience investing in money market instruments with assets under management in excess of \$500 million.
- p. Issuer must have an "A" rating or better for the issuer's debt as provided by a nationally recognized rating agency.

Figure 1b
Allowable Short-term Investment Instruments
Per State Government Code (as of January 1, 2003)^a
Applicable to counties or a city and county

Investment Type	Maximum Maturity^b	Maximum Specified Percentage of Portfolio	Additional Quality Requirements^c
U.S. Treasury Obligations	397 days	None	None
U.S. Agencies	397 days	None	None
State of California Obligations	397 days	5 percent in any one issuer	None
CA Local Agency Obligations	397 days	5 percent in any one issuer	None
Bankers' Acceptances	180 days	5 percent in any one issuer	None
Commercial Paper	270 days	5 percent in any one issuer ^d	None ^e
Negotiable Certificates of Deposit	397 days	5 percent in any one issuer ^f	None ^g
Repurchase Agreements ^h	1 year ⁱ	5 percent in any one issuer	None
Reverse Repurchase Agreements & Securities Lending Agreements ^h	92 days ^j	20 percent of the market value of the portfolio ^k	None ^l
Debt Securities Issued by Corporation or Depository Institution ^m	397 days	5 percent in any one issuer	None
Mutual Funds ⁿ	N/A	10 percent in any one mutual fund	Multiple ^o
Money Market Mutual Funds	N/A	10 percent in any one mutual fund	Multiple ^o
Contracts Issued by Insurance Companies ^p	397 days	5 percent in any one issuer	None
Mortgage and Collateral-backed Securities ^q	397 days	5 percent in any one issuer	"AA" Rating ^r
SEC Rule 2a-7 Allowable Investments	397 days	5 percent in any one issuer	None

* See "Table of Notes for Figure 1b" on page 10b for footnotes related to this figure.

Table of Notes for Figure 1b

- a. Source: Government Code Sections 53601.7
- b. A county or city and county may not invest in any security under Section 53601.7 that would cause the dollar-weighted average maturity of the funds in the investment pool to exceed 90 days.
- c. Unless otherwise specified, all corporate and depository institution investments must meet or exceed the following criteria at the time of purchase: 1) Short-term debt must be rated at least "A-1, P-1, F-1"; 2) If the issuer of short-term debt has issued long-term debt, the long-term debt must be rated "A" or better without respect to modifiers. Because Section 53601.7 does not define these investments, local agencies should consult with their legal counsel to determine if any investments purchased fall within this category.
- d. Eligible commercial paper investments may not represent more than 10 percent of the outstanding paper of an issuing corporation.
- e. Issuing corporation must be organized and operating within the U.S. and have assets in excess of \$500,000,000.
- f. Subject to the limits placed on depository funds specified in Government Code Section 53638.
- g. Eligible certificates must be issued by a nationally or state-chartered bank or a federal association, or by a state-licensed branch of a foreign bank. Investments in certificates of deposit are subject to certain restrictions on conflicts of interest as specified in Section 53601.7(e)(7).
- h. Repurchase agreements, reverse repurchase agreements, or securities lending agreements must meet the delivery requirements specified in Government Code Section 53601.
- i. A security underlying a repurchase agreement or a reverse repurchase agreement may exceed the 397-day term limit placed on all investments allowed under Government Code Section 53601.7
- j. Applies to reverse repurchase agreements unless the agreement includes a guarantee return for the entire period of the agreement.
- k. Value of portfolio based upon investments owned and does not include securities subject to other agreements, such as securities lending agreements.
- l. Investments in reverse repurchase agreements or similar investments can be made only with the approval of the governing body of the local agency and only with primary dealers of the Federal Reserve Bank of New York or with a nationally or state-chartered bank that has or has had a "significant banking relationship" with the local agency. The issuer must have held the securities used in the agreement for at least 30 days.
- m. Includes securities specified as "medium-term notes" issued by corporations organized and operating within the United States or by depository institutions licensed by the United States or any state and operating within the United States.
- n. The investments in securities and obligations made by the mutual fund must conform to Government Code Section 53601.7 except that the counterparty to a reverse repurchase agreement is not required to be a primary dealer of the Federal Reserve Bank of New York if the company's board of directors finds that the counterparty presents a minimal risk of default.
- o. Must receive the highest ranking by not less than two nationally recognized rating agencies or the fund must retain an investment advisor who is registered with the SEC or exempt from registration, has assets under management in excess of \$500 million, and has at least 5 years experience investing in money market instruments.
- p. These include guaranteed investment contracts.
- q. Category includes mortgage passthrough security, collateralized mortgage obligation, mortgage-backed and other pay-through bond, equipment lease-backed certificate, consumer receivable passthrough certificate, or consumer receivable-backed bonds.
- r. Issuer must have an "A" rating or better for the issuer's debt as provided by a nationally recognized rating agency.

Minimum legal requirement: Local agencies may invest in those instruments specified in State law.

Consensus recommendation: Include the list of permissible securities in the investment policy, and modify the list to meet the unique needs of each local agency. These modifications may include additional restrictions on the type and amount of specific authorized investments to reflect the risk tolerance of the agency.

II. B. When must the composition and credit rating of investments contained in a local agency investment portfolio be in compliance with state law? [Sections 53601 and 53601.7]

The Government Code provides a description of the types of instruments permissible for local agency investment and specifies the timing of compliance with state law.

Minimum Legal Requirement: Where the Government Code specifies a percentage restriction on a certain category of investment, this share of the investment portfolio must be in compliance with state law at the time that investment is purchased. The law does not specify that the *entire* portfolio must be in compliance when new instruments are purchased. It also does not require “rebalancing” in the case where subsequent maturities, sales, withdrawals, or similar non-purchase activities result in the remaining portfolio having one or more of the categories of investment rise above the percentage restrictions applicable at the time of purchase.

In addition, Government Code Section 53601.7 specifies (for investments purchased pursuant to this section) that any credit rating downgrade of an investment subsequent to purchase shall result in the security being reviewed for possible sale within a reasonable amount of time after the downgrade.

Consensus recommendation: None (These specific Government Code Section changes were enacted after the consensus recommendations for the *Guidelines* were adopted.)

II. C. Must bond proceeds be invested in code cited securities? [Section 53601(l)]

Section 53601(l) allows greater flexibility with respect to the types of investments that may be made with bond proceeds. Specifically, the law permits money from bond proceeds, obligations under a lease, installment sales, or other agreements of a local agency to be invested in any security that meets the statutory provisions governing the issuance of the bond or other agreements made by the issuing agency. In so doing, this section of the code both recognizes that outstanding contracts between issuers and bond holders may not comply with the revised statute and gives local agencies greater discretion in how to invest bond proceeds.

Minimum legal requirement: Bond proceeds may be invested in accordance with the Government Code provisions, or they may be invested in alternative vehicles if authorized by bond documents.

Consensus Recommendation: The agency's investment policy should either require that bond proceeds be invested in accordance with the Government Code provisions, reference applicable bond documents, or specify the types of investments authorized for bond proceeds. Agencies should make sure that language in bond documents governing the investment of bond proceeds conform to specific provisions of the agency's investment policy, if any, addressing bond proceeds.

If bond proceeds are not addressed in an agency's investment policy and are invested in a manner that is outside the investment parameters for other agency funds, the investment report still should include these funds and should note the difference in and the authority for the difference (for example, bond documents).

<p>II. D. Are all US Agency bonds legal for investment by California local agencies? [Section 53601(e)]</p>

There has been a lot of discussion about the risky nature of certain products and derivatives issued by US Agencies. These agencies offer both traditional fixed-income securities (notes and bonds) as well as other more complex, often-customized products (including derivatives). The State's investment laws, however, place no restrictions on these types of investments other than the prohibitions against inverse floaters, range notes, interest-only strips derived from mortgage pools, and securities that could result in zero-interest accrual if held to maturity. Therefore, local agencies may invest in a range of securities, including derivatives, issued by US Agencies, such as the Community Development Corporation (CDC), Federal National Mortgage Association (Fannie Mae), Government National Mortgage Association (Ginnie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac), as well as obligations from the Student Loan Marketing Association (Sallie Mae), Small Business Administration (SBA), Tennessee Valley Authority (TVA), and other federal agencies or US government-sponsored enterprises (GSE).

Minimum legal requirement: Obligations, certificates of participation, or other instruments issued by a federal agency or a United States GSE are permissible investments, subject to the prohibition against inverse floaters, interest-only strips derived from a pool of mortgages, and securities that could result in zero-interest accrual.

Consensus recommendation: Local agencies should institute restrictions that recognize the different characteristics of US Agency bonds. Generally, the higher rates of interest that some of the more customized offerings provide can be overshadowed by lower levels of liquidity and higher levels of risk. Investments in these types of products should only be entered into with a clear awareness, by both the legislative body and treasurer, of risks

involved and only if the local agency's staff has sufficient expertise to manage such investments.

II. E. What are “medium-term notes”? [Section 53601(j)]

Until recently, the Government Code simply defined medium-term notes as those instruments meeting certain term-length and quality requirements. Amendments to Government Code Section 53601(j) have attempted to clarify some of the ambiguity surrounding this definition. A variety of reasons account for this past confusion. One is that the SEC treats “corporate notes” slightly differently than “medium-term notes.” Another is that brokers often refer to corporate obligations that have an original term to maturity longer than 5 years as corporate rather than medium-term notes, even though the present term to maturity for these notes may be less than 5 years.

Minimum legal requirement: Government Code Section 53601(j) defines medium-term notes as “all corporate and depository institution debt securities with a maximum remaining maturity of five years or less.” Therefore, investments in any corporate or medium-term notes which mature within 5 years from the time of purchase are legal as long as they meet the minimum quality standards. Moreover, the Government Code specifies that local agencies may not classify investments as medium-term notes if they satisfy the definition of other allowable investments authorized under state law. For example, a local agency could not consider a security that satisfies the definition of commercial paper as a medium-term note in its portfolio.

II. F. What are the rules regarding the use of reverse repurchase agreements and securities lending agreements? [Sections 53601(i) and 53601.7(e)]

The intent of the investment laws in this area is to limit the opportunity for the imprudent use of reverse repurchase agreements (reverse repos) and securities lending agreements. In 1995, the Legislature, concerned about the use of reverse repurchase agreements for enhancing yield, imposed a number of restrictions on local governments. In 2002, the Legislature provided additional short-term investment options for a county or city and county government. As part of these options, the Legislature imposed the following restrictions on reverse repos. These include:

- Reverse repos cannot constitute more than 20 percent of the “market value” of an agency's portfolio;³

³ For reverse repos purchased under Government Code Section 53601, the calculation is based upon the “base value” of the agency's portfolio, which is defined as the dollar amount obtained by totaling all cash balances in the portfolio from all sources, excluding any amounts attained from reverse repos or similar borrowing methods.

- Reverse repos are limited to 92 days unless the minimum spread between the rate on investment and cost of funds is guaranteed in writing; and
- Securities used to make reverse repos must be held for a minimum of 30 days prior to the transaction.

Government Code Section 53601 applies the above restrictions to securities lending agreements with the exception that a local agency portfolio may not hold more than 20 percent of its base value in reverse repos and securities lending agreements combined. For local agencies that purchase securities lending agreements under Government Code Section 53601.7, their portfolios are not limited in the amount of securities lending agreements that they can hold (with the general exception that no more than 5 percent of a portfolio may be invested in any one issuer).

Minimum legal requirement: Reverse repurchase agreements and securities lending agreements may be used to take advantage of certain short-term opportunities to increase yield as well as to resolve cash flow shortages, subject to the limits noted above.

Consensus recommendation: Reverse repurchase agreements should be used primarily for resolving cash flow shortages, and should be entered into only when there is a clear awareness by both the legislative body and treasurer of the risks involved, and when the agency's staff has sufficient expertise to manage such investments. The task force did not make any recommendations regarding securities lending agreements.

II. G. What are the rules regarding the use of mutual funds and money market funds? [Sections 53601(k), 53601.6(b), and 53601.7(e)(10)]

Many have questioned the requirements regarding the types of mutual funds and money market funds that are eligible for investment. (Money market funds are also referred to as money market mutual funds in the law.)

Minimum legal requirement: The requirements under Government Code Section 53601 for investing in these funds are explained in Figure 2. The important distinction made between these two types of funds is that money market funds are not subject to the specific investment limitations of California Government Code Section 53601, while mutual funds are subject to those restrictions and local officials must verify their compliance prior to purchasing shares. Money market funds are governed by federal SEC regulations that specify diversification requirements and the types of securities that they may purchase. Money market funds are only authorized to invest in highly-rated, short-term debt instruments, but they may invest in certain ancillary agreements related to eligible securities (e.g., repurchase agreements, securities lending agreements, certain kinds of puts, etc.) that may carry a higher degree of risk. Because money market funds can only invest in securities with defined maturities, they cannot invest in equities or foreign currencies.

For local agencies investing under Government Code Section 53601.7, similar requirements apply with the exception that mutual funds must invest in securities and obligations describe in 53601.7.

Consensus recommendation: The investment policy should specify criteria for selection of both mutual funds and money market funds by the investment official.

Figure 2:
**Government Code 53601 Requirements for Local Agency Investment
in Money Market and Mutual Funds (as of January 1, 2002)**

Conditions Allowing for Investment	Money Market Funds	Mutual Funds
I. Receive the highest ranking or the highest letter and numerical rating by no less than 2 nationally recognized rating services;	X	X
Or Retain an investment advisor who is registered or exempt from registration with the SEC and has at least 5 years experience investing in specified securities and managing assets in excess of \$500 million. ¹	X	X
II. Abide by the same investment restrictions and regulations that apply to public agencies in California [Section 53601 (a-j, m-n).		X
III. Follow regulations specified by the SEC under the Investment Company Act of 1940 (15 U.S.C. Section 80a-1, et seq.).	X	

¹The requirement for mutual funds is experience investing in securities and obligations authorized in Section 53601 and 53635 of the Government Code. For money market funds, it is experience in managing the types of investments that can be purchased by money market funds as specified in SEC Regulation 2a-7.

II. H. What are the rules affecting the use of tax and revenue anticipation notes (TRANs)? [Sections 53821.5, 53841.5, 53852.5 and 53859.02(b)]

Government Code Section 53821.5 and those sections listed above prohibit the investment of TRAN proceeds in securities that have terms exceeding those of the TRAN itself. In other words, proceeds from a TRAN due June 20 may not be invested in securities that mature after June 20. The intent of these Government Code Sections is to prevent agencies from using their TRAN proceeds to purchase long-term securities in order to achieve higher investment yields in a manner which could limit liquidity needed

to ensure sufficient cash to repay the TRAN when due.

Minimum legal requirement: The minimum legal requirements are clear for securities that have an identifiable term to maturity. However, the law is ambiguous when an agency invests TRAN proceeds in items that do not have a specific maturity date, such as investments in county pools or other funds that may have an average maturity that is longer than the TRAN.

Consensus recommendation: TRAN proceeds can be invested in items that have no specific term to maturity so long as the proceeds can be removed within the period of the TRAN without a penalty. Therefore, liquid funds such as LAIF or county pools—where an agency has relatively quick access to its deposits—are legitimate investments for TRAN proceeds, as long as withdrawals in amounts sufficient to repay the TRAN when due are not restricted or penalized.

II. I. What is an appropriate safekeeping arrangement for securities? [Sections 53601 and 53608]

Many officials have questioned whether state law prohibits the safekeeping of securities in a separate department or subsidiary of the same company from which the securities were bought.

Minimum legal requirement: As long as the securities for safekeeping are in the name of or under the control of the agency and kept in a legally separate trust department, they can be held by the same firm from which they were purchased.

Consensus recommendation: Use a safekeeping service that is not related in any way to the company who sold the securities. Agencies should strive to “perfect” the delivery of securities purchased by avoiding situations where a relationship between the broker-dealer and safekeeping provider exists. Even in situations when the safekeeping function is in a subsidiary or trust department that is legally independent of its parent company, strong ties between the two may remain. In the event that the parent company fails, local agencies may have some difficulty in regaining possession of their securities from the subsidiary or trust department.

II. J. Does state law specify the fiduciary relationship that local agencies should have with outside investment management firms? [Section 53600.3]

Some officials are concerned that the State's investment laws may allow local officials to avoid any fiduciary responsibility for funds being handled by outside investment management firms. This reading of the law is not accurate. The intent of the law is for the legislative body and treasury of an agency to bear responsibility and liability for all surplus funds.

Minimum legal requirement: A finance officer or treasurer can delegate duties to an external money manager via a principal-agent relationship, but they cannot delegate fiduciary responsibility.⁴

Consensus recommendation: Contracts with external managers should allow them to make specific decisions within an established framework. Treasurers should closely monitor the actions of these individuals to ensure they are consistent with the agency's investment policy and philosophy, and demand that external managers provide timely reports that comply with the requirements of state law.⁵

II. K. In addition to the allowable investments specified in the Government Code, where else may a local agency deposit money? [Section 53635.2]

Government Code Section 53635.2 states that all local agency money may be invested in investments set forth in 53601 or deposited for safekeeping in state or national banks, savings associations, federal associations, credit unions, or federally insured industrial loan companies in this state. It also specifies certain requirements that such financial institutions must satisfy to hold local agency money.

Minimum legal requirement: To be eligible to receive local agency money, the financial institution must receive an overall rating of not less than "satisfactory" from the appropriate federal supervisory agency for meeting the criteria specified in Section 2906 of Title 12 of the United States Code (Community Reinvestment Act of 1977).⁶ The Community Reinvestment Act of 1977 requires financial institutions to demonstrate their

⁴ An official legal opinion by the Attorney General for the State of California issued in June 1996 that discusses the relationship between issuers and outside investment managers has been included in the Appendix.

⁵ A good source for more information about using money managers is the Government Finance Officers Association (GFOA) publication, *An Introduction to External Money Management for Public Cash Management*.

⁶ Government Code Section 53686 also requires that reports and/or audits concerning investments that are prepared by county treasurers must be provided to local agencies that have funds deposited in the county's investment pool. Financial institutions do not need to meet these requirements for issuing negotiable certificates of deposit to local agencies (that is, they are exempt per Government Code Section 53601(h)).

commitment to meeting the credit needs of local communities in which they are chartered to do business. For the purpose of the Act, the appropriate federal supervisory agency includes:

- The Comptroller of the Currency with respect to national banks;
- The Board of Governors of the Federal Reserve System with respect to state chartered banks that are members of the Federal Reserve system and bank holding companies;
- The Federal Deposit Insurance Corporation (FDIC) with respect to state chartered banks and savings banks that are not members of the Federal Reserve system and the deposits of which are insured by the FDIC;
- The Director of Office of Thrift Supervision with respect to savings associations (the deposits of which are insured by the FDIC) and savings holding companies.

A local agency would need to contact the appropriate federal supervisory agency to determine if its financial institution meets the overall rating requirement.